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Mutual Fund

RBI Monetary Policy Update

February 10, 2022

Bi-Monthly Monetary Policy, FY 2021-22

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Key Highlights

The RBI Monetary Policy Committee (MPC), for 10th consecutive policy meeting, decided to keep key lending rate or the repo rate "**unchanged"** and continued to maintain its stance as **"accommodative**" to revive and sustain growth on a durable basis and continue to mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target going forward.

The central bank further decided to keep Reverse Repo Rate and the Marginal Standing Facility unchanged.

Policy Tool	Pre RBI Policy	Post RBI Policy (December 8,2021)	Status
Repo	4.00%	4.00%	Unchanged
Reverse Repo	3.35%	3.35%	Unchanged
MSF	4.25%	4.25%	Unchanged
Bank Rate	4.25%	4.25%	Unchanged
CRR	4.00%	4.00%	Unchanged
SLR	18.00%	18.00%	Unchanged

MPC Keeps policy repo rate under the liquidity adjustment facility (LAF) unchanged at 4.00%. The reverse repo rate under the LAF too continues to stand at 3.35%, and the marginal standing facility (MSF) rate and the Bank Rate at 4.25%

Source: www.rbi.org.in

Economic Overview & Outlook

The first Monetary policy committee (MPC) of 2022, again surprised markets, albeit by not doing anything, and keeping status quo on all rates. With global central banks across the world doing a hawkish pivot on policies, it was expected that RBI may also start some reversal of an extremely accommodative policy stance, undertaken post COVID breakout in 2020, by increasing the reverse repo rate and reduce the corridor between reverse repo and repo rate to normal levels. However, citing uneven growth recovery, the MPC members judged that economic recovery was still incomplete and required continued monetary support. Hence, the monetary policy continues to complement the expansionary fiscal policy announced in the recent Budget for FY2022-23. For FY2023, the MPC expects GDP growth of 7.8% (down from estimated 9.2% in FY2022), with growth slowing down in 2HFY2023. The MPC further expects inflation to peak out in current quarter and expects price pressures to decrease in coming months. While they expect some upward pressure on inflation due to current increase in crude prices, they have classified as a contingent risk. Accordingly, the MPC expects average inflation to be around 4.5% in FY2023, which is near the 4% mid-point of RBI range of 4%+/-2%. Therefore, the MPC views that they can remain accommodative in light of inflation being near target as well incomplete economy recovery. On liquidity, RBI said they are likely to continue with the longer term variable reverse repo rate auctions (VRRR), with 14D VRRR remaining the main liquidity tool and other maturities of VRRR will be done as required. To shift more liquidity to VRRR, RBI is also curtailing timing when daily reverse repo and MSF (marginal standing facility) windows can be accessed. Further the Governor assured that "Monetary policy actions will be calibrated and well telegraphed", underlining that there are likely to be no surprises.

Going forward, vegetables prices are expected to ease further on fresh winter crop arrivals. The softening in pulses and edible oil prices is likely to continue in response to strong supply-side interventions by the Government and increase in domestic production. Prospects of a good Rabi harvest add to the optimism on the food price front. Adverse base effect, however, is likely to prevent a substantial easing of food inflation in January. The outlook for crude oil prices is rendered uncertain by geopolitical developments even as supply conditions are expected to turn more favourable during 2022. While cost-push pressures on core inflation may continue in the near term, the Reserve Bank surveys point to some softening in the pace of increase in selling prices by the manufacturing and services firms going forward, reflecting subdued pass-through. On balance, the inflation projection for 2021-22 is retained at 5.3 per cent, with Q4 at 5.7 per cent. On the assumption of a normal monsoon in 2022, CPI inflation for 2022-23 is projected at 4.5 per cent with Q1:2022-23 at 4.9 per cent; Q2 at 5.0 per cent; Q3 at 4.0 per cent; and Q4:2022-23 at 4.2 per cent, with risks broadly balanced.

Recovery in domestic economic activity is yet to be broad-based, as private consumption and contact-intensive services remain below pre-pandemic levels. Going forward, the outlook for the Rabi crop bodes well for agriculture and rural demand. The impact of the ongoing third wave of the pandemic on the recovery is likely to be limited relative to the earlier waves, improving the outlook for contact-intensive services and urban demand. The announcements in the Union Budget 2022-23 on boosting public infrastructure through enhanced capital expenditure are expected to augment growth and crowd in private investment through large multiplier effects. The pick-up in non-food bank credit, supportive monetary and liquidity conditions, sustained buoyancy in merchandise exports, improving capacity utilisation and stable business outlook augur well for aggregate demand. Global financial market volatility, elevated international commodity prices, especially crude oil, and continuing global supply-side disruptions pose downside risks to the outlook. Taking all these factors into consideration, the real GDP growth for 2022-23 is projected at 7.8 per cent with Q1:2022-23 at 17.2 per cent; Q2 at 7.0 per cent; Q3 at 4.3 per cent; and Q4:2022-23 at 4.5 per cent.

The MPC notes that inflation is likely to moderate in H1:2022-23 and move closer to the target rate thereafter, providing room to remain accommodative. Timely and apposite supply side measures from the Government have substantially helped contain inflationary pressures. The potential pick-up of input costs is a contingent risk, especially if international crude oil prices remain elevated. The pace of the domestic recovery is catching up with pre-pandemic trends, but private consumption is still lagging. COVID-19 continues to impart some uncertainty to the future outlook. Measures announced in the Union Budget 2022-23 should boost aggregate demand. The global macroeconomic environment is, however, characterized by deceleration in global demand in 2022, with increasing headwinds from financial market volatility induced by monetary policy normalization in the systemic advanced economies (AEs) and inflationary pressures from persisting supply chain disruptions. Accordingly, the MPC judges that the ongoing domestic recovery is still incomplete and needs continued policy support.

The market reacted positively to the MPC policy, with 10Y dropping by about 10bps. The shorter end of the curve saw more rally, as RBI did not touch the reverse repo rate with 1yr rates dropping by 10-15bps. The recent partial/full cancellation of auctions had improved market sentiment leading to the policy and the positivity continued with RBI holding pat on rates. After touching a high of 6.95% in the Feb, 10Y GSEC has since retraced and currently at 6.72%. With only 2 more auction scheduled in current fiscal, supply pressure has eased. In the short term market may remain buoyant, however the large borrowing of FY2023 is likely to remain in market's mind and any further rally is likely to be limited. In the short term 10Y Gsec may remain in range of 6.65-6.95%.

Source: RBI, Bloomberg, internal research

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